Petitioner,

v.

[illegible] (SOUTH DAKOTA), N.A.,

Respondent.

[illegible] CERTIORARI [illegible]
[illegible] SUPREME COURT

[illegible] OF
[illegible] ASSOCIATION,
[illegible] ASSOCIATION,
[illegible] ASSOCIATION,
[illegible] INTERNATIONAL INCORPORATED,
NATIONAL RETAIL FEDERATION
AND VISA U.S.A. INC. IN SUPPORT OF
RESPONDENT CITIBANK (SOUTH DAKOTA), N.A.

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

STATUTES, REGULATIONS & RULES

OTHER AUTHORITIES

Page(s)

Page(s)

INTEREST OF AMICI

This amici curiae brief is filed by American Bankers Association ("ABA"), American Financial Services Association ("AFSA"), Consumer Bankers Association ("CBA"), MasterCard International Incorporated ("MasterCard"), National Retail Federation ("NRF"), and VISA U.S.A. Inc. ("VISA") (collectively, "Amici") in support of respondent Citibank (South Dakota), N.A.[1]

The ABA is the largest national trade association of the commercial banking industry in the United States, representing approximately 90 percent of the domestic assets of all American commercial banks. The AFSA represents over 300 companies, including many depository institutions, that operate more than 10,000 offices extending consumer credit in the United States. The CBA represents institutions that collectively hold nearly 80 percent of all consumer deposits and about 70 percent of all consumer credit held by federally-insured depository institutions. VISA and MasterCard are associations that, as of year-end 1994, had approximately 17,000 and 13,600 depository institution members, respectively. The NRF is a trade association comprised of more than 55,000 members who are engaged in retail businesses throughout the United States.

Depository institutions are vitally interested in the question of whether late fees on credit card accounts are "interest" within the meaning of 12 U.S.C. § 85 ("Section 85"). That section governs the interest that may be charged on any loan made by a national bank, but other banks, savings associations, and credit unions also are affected by this Court's interpretation of Section 85 because Sections 521-523 of the Depository Institutions Deregulation

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[1] Petitioner and Respondent each have provided consent to Amici's filing, pursuant to Supreme Court Rule 37.3.

and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) ("DIDA"), grant these institutions the same federal interest authority that national banks have under Section 85. Members of the NRF are affected significantly by Section 85 because credit cards issued by depository institutions provide a crucial payment mechanism and source of credit necessary for the retail sales industry.[2]

Federally-insured depository institutions have relied on the long-standing interpretation of Section 85 by the Office of the Comptroller of the Currency ("OCC") in lending tens, if not hundreds, of billions of dollars on interstate credit card programs. If the OCC's position is set aside in this case, these credit card issuers could be subject to late fee limits under the various laws of the borrowers' states. Over 45 lawsuits and state administrative enforcement actions on this issue have been filed in recent years in Alabama, California, Colorado, Iowa, Maine, Massachusetts, Minnesota, New Jersey, Pennsylvania, South Carolina, and Wisconsin. If the theories asserted by the plaintiffs in these cases were successful, the potential liability under state law could include loss of periodic percentage charges on the accounts, as well as multiples of the late fees being challenged, for the applicable statute of limitations period under state law. Any such result would seriously undermine the justifiable reliance that depository institutions have placed on the federal banking agencies' interpretations of the laws they administer.

SUMMARY OF ARGUMENT

The OCC, the federal regulatory agency charged with interpreting and enforcing the National Bank Act, has issued a

[2] This brief relates to credit cards issued by depository institutions, and does not address credit cards issued by retailers. The members of the NRF thus, in this brief, express the views of merchants that accept credit cards rather than issuers of credit cards.

regulation that late fees are covered by Section 85. 61 Fed. Reg. 4849, 4869 (1996) (to be codified at 12 C.F.R. § 7.4001(a)). This interpretation reflects the agency's long-held position and is supported by extensive authority, including this Court's decisions which hold that the term "interest" includes "compensation allowed by law, or fixed by the parties, for the use or forbearance of money, or as damages for its detention." *Brown v. Hiatts*, 82 U.S. (15 Wall.) 177, 185 (1873).[3] The OCC's regulation thus should be controlling in this case. *See NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 813 (1995).

Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978), established conclusively that a national bank is authorized by Section 85 to charge interest at the rate allowed by the laws of the state in which the bank is located on loans made to borrowers who reside in other states (the "home state interest rule"). In doing so, this Court recognized that Section 85 was intended to foster national competition that allows borrowers to choose from a wide variety of credit products offered by lenders located nationwide under the laws of their respective states. Congress reaffirmed the primary importance of such national competition by providing other federally-insured depository institutions with the benefits of the home state interest rule when it enacted Sections 521-523 of DIDA.

Marquette recognized that borrowers shop nationally for credit by interstate mail and telephone. Borrowers now also can obtain interstate credit through computer networks. Section 85 provides that the interest laws of the bank's state apply to these interstate loans, just as if the borrower were to obtain a loan by physically visiting a branch of the bank in

[3] The compelling reasoning for this interpretation is restated at length in OCC Interpretive Letter No. 676, *reprinted in* [1994-1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,618 (Feb. 17, 1995).

another state. The laws of the borrower's state are not properly applied to such interstate transactions occurring in the bank's state.

The benefits of national competition in the credit industry are well-illustrated by the credit card industry, which is the subject of this brief. This Court's decision in *Marquette* and the home state interest rule have been instrumental in developing true national competition.[4] Credit card issuers located across the country vie for the business of borrowers who reside in every state. The result has been what the Board of Governors of the Federal Reserve System ("Board") has described as an intensely competitive credit card industry. Indeed, the industry is structurally competitive by traditional measures, and its growth, entry of new competitors, aggressive competition for new customers, and competitive pricing and profitability all belie any assertion that the industry does not perform competitively.

Petitioner's interpretation of Section 85 would eviscerate *Marquette* by allowing state-by-state regulation of a significant component of the loan compensation on interstate credit cards.[5] Periodic percentage charges, late fees and other interest charges on credit card accounts are interdependent as a matter of both law and economics. Requiring state-by-state compliance with late fee limits effectively would require state-by-state compliance with all elements of loan compensation

[4] *See* William F. Baxter, *Section 85 of the National Bank Act and Consumer Welfare*, 1995 Utah L. Rev. 1009, 1021 (1995) ("Baxter") (citations to page proofs obtained from publisher); David S. Evans and Richard L. Schmalensee, *The Economics of the Payment Card Industry* 29 (1993) ("Evans & Schmalensee").

[5] For ease of reference, this brief refers to interest (compensation for the use, forbearance or detention of money) as "loan compensation."

and unduly interfere with national competition in the credit card industry.

Petitioner's argument also fails to recognize that this Court has held that Section 85 incorporates state law on the permissible methods (or rates) by which interest is calculated, and not merely any limit on the ultimate amount of interest that may be charged. *See, e.g., Citizens' Nat'l Bank v. Donnell*, 195 U.S. 369 (1904). The laws of the bank's state thus determine whether loan compensation may be calculated by a flat or percentage rate, and whether applicable rates are applied during the term of the loan to calculate periodic charges or, when a borrower misses a payment, to calculate a late fee. The laws of the bank's state therefore determine the permissible allocation of loan compensation between the APR and late fees.[6]

If Section 85 does not apply to late fees, the federal standard can prove unworkable in many situations because Section 85 would adopt only a portion of the state standard that relates to loan compensation. For interstate loans, Section 85 thus could create an unworkable hodgepodge of laws of the bank's state and the borrower's state that was not intended by either state, and could cause anamolous results that adversely affect national competition.

Petitioner's theories, if accepted, would harm consumers. The home state interest rule allows consumers to choose from alternative price structures (methods of calculating loan compensation) under the laws of any state in the nation. Consumers can choose the price structure that best meets their individual needs. Limits on permissible price structures through limits on late fees preclude competitive pricing in

[6] For purposes of this brief, the term "APR" refers to the annual percentage rate that corresponds to the monthly or other periodic percentage rate charged on the account.

which late payers who present higher credit risks and cause increased operational expenses can be charged appropriately without subsidization from other borrowers.

Imposing state law limits on the price at which credit is made available in the competitive credit card industry unnecessarily restricts the availability of credit, particularly to those borrowers that have the most difficulty obtaining credit. Petitioner's interpretation of Section 85 also needlessly applies multiple state laws on the price of credit cards, which decreases the efficiency of providing credit card services and leads to higher prices and/or lower-quality services for consumers.

In sum, Petitioner's arguments should be rejected because they are inconsistent with both the congressional policies underlying Section 85 and this Court's decisions, and do not benefit consumers.

ARGUMENT

I. SECTION 85 HAS PROMOTED NATIONAL COMPETITION IN THE CREDIT CARD INDUSTRY

Marquette firmly establishes that Congress adopted the home state interest rule in Section 85 with full knowledge of the extensive interstate lending activities in which national banks would be engaged. The Court explained:

> [The] debates [surrounding Section 85] occurred in the context of a developed interstate loan market. As early as 1839 this Court had occasion to note: "Money is frequently borrowed in one state, by a corporation created in another. The numerous banks established by different states are in the constant habit of contracting and dealing with one another. . . . These usages of commerce and trade have been so general and public, and have been practiced for so long a period of time, and so generally acquiesced in by the states, that the Court cannot overlook them . . . ." Examples of this interstate loan market have been noted by historians of American banking. Evidence of this market is to be found in the numerous judicial decisions in cases arising out of interstate loan transactions.

439 U.S. at 317 (alterations in original; citations omitted). *Marquette* thus recognized that Section 85 authorizes national banks located in different states with different interest laws to compete with each other nationally on the basis of the interest charges allowed by their home states.

When Section 85 was first enacted at the time of the Civil War, there were good reasons to adopt federal banking laws that would facilitate interstate commerce among the then-divided states. Through the home state interest rule, Congress prevented balkanized state credit industries by ensuring that national banks could compete freely on a national basis. From the borrowers' perspective, the rule ensured that they would have the opportunity to obtain credit at national prices in the truest sense: any price allowed by the laws of any state in the nation. Section 85 thus significantly increased both the available sources and the terms of credit.

The national competition recognized by *Marquette* occurs when borrowers who reside in one state obtain a loan product in another state at the price allowed by the other state. In upholding the home state interest rule against the claim that it improperly impaired the states' ability to "enact effective usury laws," *Marquette* noted that such impairment "has always been implicit in the structure of the National Bank Act,

since citizens of one State were free to visit a neighboring State to receive credit at foreign interest rates" and that such impairment "may in fact be accentuated by the ease with which interstate credit is available by mail through the use of modern credit cards." *Id.* at 318-19. *Marquette* thus established that a borrower obtains an interstate loan in the bank's state as if he or she visited that state in person. *Cf.* 12 U.S.C. § 81 (a national bank must conduct its loan business at its licensed branches or main office).

Congress reaffirmed its commitment to national competition in the credit industries, including the credit card industry, just two years after *Marquette* when Sections 521-523 of DIDA were enacted. This legislation provided other federally-insured depository institutions with the same interest authority that national banks have under Section 85.[7] Other federally-insured lenders thus were authorized to offer their home states' interest rates nationally without regard to state limits under the laws of the borrowers' states. The result was increased national competition from numerous other federally-insured depository institutions.

The enactment of Sections 521-523 of DIDA is significant in at least two respects. First, these federal statutes were enacted with the express congressional goal of establishing competitive equality between the other federally-insured depository institutions and national banks regarding the interest that could be charged. *See Greenwood Trust Co. v. Massachusetts*, 971 F.2d at 826. The ability to charge home state interest on interstate loans was a significant competitive advantage that national banks had over other depository institutions before enactment of Sections 521-523 of DIDA.

[7] *See generally Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818 (1st Cir. 1992) (Section 521), *cert. denied*, 506 U.S. 1502 (1993); *Gavey Properties/762 v. First Fin. Sav. & Loan Ass'n*, 845 F.2d 519 (5th Cir. 1988) (Section 522).

Absent that authority, borrowers would not have the choice of the pricing offered by these depository institutions under the laws of other states.

Second, Sections 521-523 of DIDA were enacted when interest rates were at historic highs and low interest rate limits under some state laws significantly reduced the availability of credit to the point of adversely affecting the economy. *Id.* Sections 521-523 helped alleviate this credit crunch by authorizing additional depository institutions located in higher interest rate states to charge those rates to borrowers in low-rate states.

The importance of national competition in the credit card industry increases almost daily with fast-paced technological advances. Just as developments in interstate mail and telephone systems have facilitated the ability of cardholders to obtain credit in the bank's state, borrowers currently can obtain credit from a multitude of lenders nationwide through computer networks such as the Internet.[8] As technological advances quickly expand consumers' access to credit in other states, the home state interest rule embodied in federal law preserves for consumers the ability to shop for credit in different states and to obtain credit products available under those states' laws.[9]

[8] *See, e.g.*, *Vendors Join First Union in Its Electronic Mall*, Am. Banker, Aug. 11, 1995, at 9 (bank offering applications for credit cards on-line); Tracey Tucker, *Discount Mortgage Broker to Originate Loans On-Line Via Compuserve*, Am. Banker, July 27, 1995, at 16 (mortgage broker offering on-line mortgage loan brokerage services and anticipates soon offering other credit services, including credit cards).

[9] The OCC has recognized that technological developments increase access to banking services, including credit, for lower income individuals. *See* Eugene A. Ludwig, Comptroller of the Currency, *A Profitable Market Opportunity*, Remarks Before the Community Development Conference, OCC N.R. 96-21 (Feb. 23, 1996).

To be sure, there is a tension between the home state interest rule and the ability of a state to regulate the conduct of its citizenry, albeit conduct outside the state's borders. However, as *Marquette* recognized, the "protection of state usury laws is an issue of legislative policy, and any plea to alter § 85 to further that end is better addressed to the wisdom of Congress than to the judgment of this Court." 439 U.S. at 319. Congress, after *Marquette*, examined the wisdom behind Section 85 when it considered Sections 521-523 of DIDA and reaffirmed the primary importance of national competition by extending the home state interest rule to additional lenders.

II. THE CREDIT CARD INDUSTRY IS INTENSELY COMPETITIVE

Congress's efforts to promote national competition in the credit industries have been unambiguously successful in the credit card industry. In September 1995, the Board reported to Congress that competition in the credit card industry remains intense, with thousands of firms offering credit cards to consumers.[10] The Board found that the credit card industry has been characterized by growth, new entry, aggressive competition for new customers, and competitive pricing and profitability. FRB Report at 7-9. A number of governmental and academic economists who have studied competition in the credit card industry have reached the same conclusion.[11]

[10] Board of Governors of the Federal Reserve System, "*The Profitability of Credit Card Operations of Depository Institutions*," An Annual Report Submitted to Congress Pursuant to Section 8 of the Fair Credit and Charge Card Disclosure Act of 1988, at 6 (Sept. 1995) ("FRB Report").

[11] *E.g.*, Baxter at 1014; Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. Pol. Econ. 400 (1995) ("Brito & Hartley"); Loretta J. Mester, *Why Are Credit Card Rates Sticky?*, 4 Econ. Theory 505 (1994) ("Mester"); Glenn B. Canner & Charles A. Luckett, *Developments in the Pricing of Credit Card Services*, 78 Fed. Res. Bull. 652 (Sept. 1992) ("Canner & Luckett"); Alexander Raskovich & Luke Froeb, *Has Competition Failed in the Credit Card Market?* (U.S. Dep't of Justice Antitrust Div. Econ. Analysis Group, Working Group Paper 92-7, June 12, 1992) ("Raskovich & Froeb"); Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, Yale J. on Reg. 201 (1986) ("DeMuth").

In assessing the competitiveness of an industry, courts and economists generally focus on three factors: (1) the structure of the industry; (2) the conduct of firms in the industry; and (3) the economic performance of the industry. *See United States v. General Dynamics Corp.*, 415 U.S. 486, 501-06 (1974); F.M. Scherer & David Ross, *Industrial Market Structure and Economic Performance* 4-5 (3d ed. 1990) ("Scherer & Ross"). Measured against any of these indicia, the credit card industry is highly competitive.

A. The Industry Is Structurally Competitive

Economic analysis of industrial competitiveness generally begins with an examination of industry structure because, in the absence of industrial concentration, it is highly unlikely that firms will be able to act individually or collectively to lessen competition. Scherer & Ross at 71. *See also United States v. Philadelphia Nat'l Bank*, 374 U.S. 321, 363 (1963). The Herfindahl-Hirschman Index (or "HHI") is the tool most commonly used to measure industrial concentration. Scherer & Ross at 72. Markets with an HHI of less than 1000 are considered by the Justice Department and the Federal Trade Commission to be "unconcentrated."[12] In studies of the credit

[12] U.S. Dep't of Justice and Federal Trade Comm'n, *Horizontal Merger Guidelines* § 1.5 (Apr. 2, 1992) ("DOJ/FTC Merger Guidelines") *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104; *see also* IIA Phillip E. Areeda, Herbert Hovenkamp & John L. Solow, *Antitrust Law* ¶ 404d at 18 (1995) (effects of industrial concentration on

card industry, courts and analysts have consistently found the industry to be "unconcentrated" and "atomistic," with an HHI of 564 or less.[13] *See SCFC ILC, Inc. v. VISA USA, Inc.*, 36 F.3d 958, 967-68 & n.13 (10th Cir. 1994) (HHI is below 500), *cert. denied*, 115 S. Ct. 2600 (1995).[14]

One of the principal reasons why the credit card industry is so unconcentrated is that there are "few barriers to entry for depository institutions that wish to issue credit cards." GAO Report at 25. Virtually any federally-insured bank, savings association, or credit union can join the MasterCard or VISA system and issue its own card. Indeed, since *Marquette*, the number of issuers has grown dramatically. "Approximately 4,500 of the 6,000 depository institutions that issue credit cards joined VISA and/or MasterCard between 1980 and 1991." *Id.*[15] Each of these institutions determines the specific

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profitability "seem generally to disappear once the share of the four leading firms falls below 50 to 55 percent or the Herfindahl falls below 1,000").

[13] Credit card issuers compete not only against one another, but also against other methods of payment, including proprietary credit cards (issued by department stores, oil companies and the like), debit cards, checks and cash. The HHI would be significantly lower if these competing payment methods were included in the calculus.

[14] *See also* U.S. General Accounting Office, *United States Credit Card Industry: Competitive Developments Need To Be Closely Monitored* 25 (April 1994) ("GAO Report") ("most analysts place the HHI value for the credit card industry at less than 564").

[15] Many of the recent entrants into the industry have been quite successful. For example, the Discover Card (launched in 1985) and the AT&T Universal Card (first offered in 1990) have become the third and sixth largest credit card programs, respectively, based on outstanding balances. *Top 50 Companies in Managed Bank Credit Card Loans*, Am. Banker, Sept. 11, 1995, at 33-34.

package of services it will offer, and independently sets the price and terms of its product offerings.

B. The Industry Is Characterized By Aggressive National Competition

Credit card issuers offer a wide array of credit card products. These products differ in both price and service dimensions, including annual fees, APRs, late fees, rebates or discounts on purchases, and a variety of other "enhancements," such as frequent flier miles and travel accident insurance. Credit card issuers compete aggressively against one another in each of these product dimensions, offering cards with different combinations of features designed to appeal to particular classes of customers. *See* Canner & Luckett at 654.

Although the Amicus Curiae Brief of Consumer Action argues (at 15-16) that average credit card APRs "have remained virtually constant at approximately eighteen percent" for several years, and that the "stability" of APRs on credit cards is the result of an absence of "market competition," neither claim is correct.

The average APR statistics cited by amicus Consumer Action conceal the vigorous price competition found in the industry today. This is because the statistics cited are calculated by taking the unweighted average of APRs charged by a sample of large banks to *some* of their customers; they "[do] not capture the diversity of interest rates that a typical issuer may offer its entire customer base," including lower fixed rate and variable rate plans. GAO Report at 15. In fact, the Board reported last fall that many credit card issuers, including nearly all of the largest issuers, have lowered APRs on many of their accounts. FRB Report at 7. A 1992 study by two Board economists observed that, of the 150 issuers studied, "[s]eventeen percent of the issuers . . . charged rates

below 16 percent per year. Nearly one-fourth offered variable-rate plans . . . [and] an additional 4 percent offered plans with a tiered rate structure, in most cases assessing lower rates on higher balances." Canner & Luckett at 654-55. The economists emphasized that, because the survey collected information about each issuer's largest plan (rather than all of its plans), "[u]ndoubtedly, the variety in the marketplace is even greater" than the survey suggests. *Id.*

The Board's 1995 report to Congress provides further evidence of the intense price competition among issuers. It observes that "[s]everal of the more rapidly growing firms in recent years . . . appear to have attracted market share by offering comparatively low-rate cards." FRB Report at 7. Other issuers, the Board notes, have competed by changing other price terms, "gain[ing] market share through co-branding and associated rebate strategies, typically combined with waivers of annual fees." *Id.*

Acknowledging the intensity of competition among credit card issuers, some analysts have argued that the supposed stability of APRs on credit cards presents an economic anomaly.[16] In a competitive industry, they contend, APRs should move in tandem with the cost of funds, yet they do not. As the Board observes, however, the fact is that APRs generally have become more responsive to the creditor's cost of funds, with about two-thirds of the card issuers basing their APRs on an index that moves with other borrowing rates. *Id.*

To be sure, a number of issuers still offer credit cards with fixed APRs. Economists at the Board, at the Department of Justice, and in academia, however, have studied why the APRs on these cards do not move in perfect correlation with

[16] *See, e.g.*, Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, 81 Am. Econ. Rev. 50 (1991).

indices for other borrowing rates.[17] Their conclusion is that this alleged anomaly does not reflect a failure of competition. On the contrary, they explain, in a competitive market these rates should *not* move in tandem with changes in the cost of funds. The principal reason is that an estimated fifty to seventy-five percent of the cost of credit card operations is unrelated to the cost of funds, and thus does not change in response to changes in that cost. Baxter at 1016.

In addition to price competition, issuers vie for customers by offering enhanced features and services. *See* Robert H. Bork, *The Antitrust Paradox* 189 (1978) ("Product rivalry [is] a much more unstable and unsettling form of competition than price rivalry . . ."). For example, the Board notes that "MBNA continues to gain market share by its use of an aggressive affinity card marketing approach." FRB Report at 8. A study by Board economists likewise reports that, beginning in the mid-1980s, "many banks, especially those operating nationwide, became much more aggressive in marketing credit card accounts," including through "offering more card 'enhancements,' such as travel accident insurance, auxiliary rental car insurance, and other distinctive features that varied among issuers." Canner & Luckett at 654.

Millions of consumers have responded to this national competition by moving their account balances when offered more favorable features and terms. Issuers, as a result, are increasing the number of offerings they make available; "[m]ore than 2 billion direct mail solicitations were sent by issuers during 1994" alone. FRB Report at 8 n.12. These offerings frequently are accompanied by special incentives to switch. The Board reports that "many issuers have attempted to gain or maintain market share by offering very low,

[17] *E.g.*, Baxter at 1015-19; Brito & Hartley at 429; Mester at 505-07; Raskovich & Froeb at 11-12; DeMuth at 228-31.

temporary rates on balances rolled over from competing firms." *Id.* at 7. The AT&T Universal Card, for example, "attained top-ten status within months of its inauguration primarily by inducing switches from rival cards." Raskovich & Froeb at 1 n.1. The pace of consumer switching has accelerated in recent years. Indeed, during the first half of 1994 alone, "VISA cardholders transferred some $10.8 billion between issuers, almost six times more than during the same period in 1992." FRB Report at 8 n.12.

C. The Performance Of The Industry Reflects Its Competitive Structure

The economic performance of the credit card industry over the last decade reflects the intense competition described above. As this Court has observed, non-competitive industries tend to be characterized by restricted output, limited entry, and stable market shares. *See, e.g.*, *National Collegiate Athletic Assoc. v. Board of Regents*, 468 U.S. 85, 106-07 (1984) (absent competition, "[p]rice is higher and output lower than they would otherwise be, and both are unresponsive to consumer preference"); *see also* DOJ/FTC Merger Guidelines § 2.1. The credit card industry, as even its critics acknowledge, has none of these characteristics.

The supply of credit available through credit card lending has grown dramatically over the last fifteen years. *See* Amicus Brief of Consumer Action at 6. As the GAO observes, before the 1980s, state usury laws "suppressed the growth of the credit card industry insofar as issuers in states with low [APR] ceilings issued cards only to the most creditworthy individuals." GAO Report at 12-13. This Court's decision in *Marquette* enabled issuers to expand the base of customers they served, leading to a significant surge in demand for credit card loans during the 1980s. *Id.* at 13. Indeed, the GAO found that "[t]he percentage of American households with at least one credit card grew rapidly during

the 1980s, from about 38 percent in 1977 to 54 percent in 1989." *Id.* The Board reports that this trend has continued unabated: "The aggressive competition for new customers during 1994 was at least partly the cause of a 19 percent increase from 1993 in the number of VISA and MasterCard [credit cards] in circulation, to a total of 341.3 million." FRB Report at 8.

New credit card offerings have come from established issuers and new entrants alike. These companies have fought vigorously with one another for credit card customers nationwide by offering a diverse array of products with different prices and features. This competition, in turn, "has led to substantial shifts in market shares among the industry's largest firms" over the past several years. *Id.* at 7. Where, as here, a national industry is characterized by rapid growth, significant new entry, price competition, innovative product offerings, and significant shifts among the industry leaders, there can be no doubt that it is functioning in a competitive manner.

Some doubts have been expressed, however, by critics of the industry who believe that the profits earned by credit card issuers are abnormally high. *See* Amicus Brief of Consumer Action at 13-14. Economists at the Board and at the Department of Justice, as well as a number of academic economists, have studied these allegations and rejected them.[18] Measured properly, rates of return on credit card operations are consistent with the rates of return earned by enterprises engaged in businesses of comparable risk.

To begin with, there is conflicting evidence on the question of whether the rates of return earned by credit card operations are, in fact, higher than those earned by other

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[18] Baxter at 1018-19; Brito & Hartley at 429; Raskovich & Froeb at 11-12 & n.10; Canner & Luckett at 661-62.

enterprises. The Board's 1995 report to Congress on the profitability of credit card operations of depository institutions observes that, based on one set of time series data, "credit card operations have not been exceptionally profitable." FRB Report at 3. From 1974 through 1994, "the annual net earnings of bank credit card plans averaged 2.26 percent of balances outstanding," while "average net returns on other major types of bank lending have been quite similar: 2.42 percent on real estate mortgages, 2.26 percent on commercial and other loans, and 2.26 percent on installment loans." *Id.*

More importantly, the rates of return cited by the industry's critics are *accounting* rates of return. As Professor Baxter observes, however, "high accounting returns do not imply high economic profits." Baxter at 1018. With respect to credit card operations specifically, the use of this measure "tends to overstate the profitability of credit card operations relative to other lending services." *Id.* This is because credit card operations require the use of far more non-capital assets, such as marketing, advertising, and customer service. As an accounting matter, these expenditures are treated as expenses, not assets, and therefore are excluded from the base of "assets" on which the accounting rates of return are calculated. *Id.*; *see also* Raskovich & Froeb at 11 n.10.

Finally, as this Court has recognized, in a competitive industry the rate of return earned by a particular business will be commensurate with the level of risk incurred by that business. The higher the risk of an enterprise, the higher the return it must provide investors to attract capital. *See FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Bluefield Water Works & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692-93 (1923). Credit card lending therefore "should be more profitable than other forms of bank lending because it is accompanied by greater risk." Baxter at 1019. In fact, economists who have carefully studied rates of return associated with credit card operations have concluded that, on

a risk-adjusted basis, these rates of return are consistent with those earned by other competitive enterprises.[19]

III. LOAN COMPENSATION MAY BE CALCULATED IN THE MANNER ALLOWED BY THE LAWS OF A NATIONAL BANK'S HOME STATE

Section 85 promotes national competition in the manner of calculating loan compensation, and not merely in the amount of loan compensation. Thus, this Court's decisions recognize that Section 85 applies to the method by which interest is calculated as well as the amount of interest.

Indeed, a fundamental policy underlying Section 85 is to protect national banks against unfriendly state laws regulating interest. *Tiffany v. Nat'l Bank of Missouri*, 85 U.S. (18 Wall.) 409, 412-13 (1874). Federal law would provide little, if any, protection to national banks if states could favor other lenders through the manner in which loan compensation is calculated. Section 85 therefore must incorporate as the federal standard not only the amount of loan compensation allowed by state law, but also the manner in which such loan compensation is calculated under state law. *See Daggs v. Phoenix Nat'l Bank*, 177 U.S. 549, 555 (1900). Section 85, for example, incorporates state law relating to the compounding of periodic percentage charges, independent of state law limits on total loan compensation. *See Citizens' Nat'l Bank v. Donnell*, 195 U.S. at 374; *see also American Timber & Trading Co. v. First Nat'l Bank of Ore.*, 511 F.2d 980, 983 (9th Cir. 1973), *cert. denied*, 421 U.S. 921 (1975) (calculation on a 365/360-day basis).

[19] Joseph F. Sinkey & Robert C. Nash, *Assessing the Riskiness and Profitability of Credit-Card Banks*, 7 J. Fin. Services Res. 127, 144 (1993); *see also* Brito & Hartley at 429; Canner & Luckett at 661-62; Raskovich & Froeb at 11-12 & n.10.

A. Late Fees Involve A Method Of Calculating Loan Compensation

Section 85 authorizes the collection of loan compensation at the "rate" allowed by state law. Thus, the laws of the state where the national bank is located govern whether loan compensation may be calculated, for example, using a one-time flat rate or a periodic percentage rate. *See Greenwood Trust Co.*, 971 F.2d at 824. Similarly, Section 85 incorporates state laws regarding *when* the rates for determining loan compensation may be applied: during the term of the loan (*i.e.*, as periodic percentage charges) and/or at delinquency (*i.e.*, as late fees).

Petitioner's argument that late fees are not covered by Section 85 fails to recognize that Section 85 incorporates state law on the permissible methods (rates) by which interest can be calculated. The OCC and case law recognize that interest includes loan compensation, and that late fees are loan compensation. Petitioner's claim essentially is that late fees are not covered by Section 85 because the manner in which the loan compensation is calculated is not covered by Section 85. But under the home state interest rule, the laws of the bank's state determine not only the amount of loan compensation, but also the manner of calculating the compensation, and thus the allocation of the compensation between the APR and late fees.

The fallacy of Petitioner's argument is illustrated by considering three price structures (or calculation methods) that a credit card issuer might adopt for cardholders who pay late: (1) the periodic percentage charge could be set at a higher rate at the time the loan is made on the basis of the cardholder's late payment history on other loans; (2) the periodic percentage charge for a loan could be increased after late payments on that loan; or (3) a fee could be assessed for each late payment, calculated on the late payment amount and

the delinquency period. In Petitioner's view, Section 85 draws an artificial distinction between these price structures and flat late fees. In fact, although these alternative calculation methods (rates) differ from a flat fee assessed upon late payments, they all are covered by Section 85.[20]

B. The Potentially Unworkable Hodgepodge Of State Laws

State laws that limit credit prices commonly impose comprehensive and interrelated limits on the permissible amount of, and methods of calculating, loan compensation.[21] A state thus may require all loan compensation to be included in periodic percentage charges and prohibit all other loan compensation. Another state may allow loan compensation through a combination of periodic percentage charges and up-front fees (*e.g.*, origination fees). Yet another state may allow flexibility in the price structure that can be offered, either with or without a limit on the amount of loan compensation.[22]

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[20] After Iowa challenged the ability of out-of-state banks to charge late fees in 1988, one credit card issuer merely converted the manner in which it calculated interest by imposing higher periodic percentage charges after late payment rather than late charges. *See* A. Joseph Newman, Jr., *Delaware Bank Finds Way to "Export" Card Fees*, Am. Banker, Aug. 31, 1988, at 2.

[21] *See, e.g.*, Pa. Stat. Ann. tit. 69, § 1906 ("the service charge shall include all charges incident to investigating and making" the credit card account, and "[n]o fee, expense, delinquency, collection or other charge whatsoever" may be collected if not provided for in the statute); N.J. Stat. Ann. 17:16C-50 (no "further or other amount for costs, charges, . . . expense, interest, discount, fees, fines, penalties or other things of value" are allowed unless expressly permitted).

[22] For example, a state may limit the amount of loan compensation by imposing a maximum yield calculated on an actuarial basis, and still allow the lender flexibility to adopt whatever price structure the lender chooses by which to receive that compensation.

Petitioner's argument that Section 85 incorporates only a portion of state law governing the manner of calculating loan compensation, if accepted, could render the statute unworkable. Some state laws limit the total loan compensation including late fees, *see, e.g.*, Wisc. Stat. Ann. §§ 421.301(20), 422.201(10m) (finance charges, which are limited under state law, may include late fees), while other states allow late fees only if periodic percentage charges are not imposed on loan balances that are paid late. *See, e.g.*, Mont. Code Ann. § 31-1-235. Petitioner suggests that a loan to a borrower in one of these states would be subject to the limit on late fees, but would not be subject to limits on periodic percentage charges. It would be difficult, however, if not impossible, to determine compliance with such an unintended and unpredictable patchwork of laws from the bank's state and the borrower's state.

Petitioner's reading of Section 85, if adopted, would adversely affect national competition in the credit card industry. The laws of the bank's state might provide for late fees to compensate for a relatively low periodic percentage charge, while the laws of the borrower's state might permit a relatively high periodic percentage charge and prohibit late fees. Petitioner's interpretation could result in the bank's charging a relatively low periodic percentage charge set by its state, but not being able to charge the late fee that the bank's state intended to compensate for the low periodic percentage charge. This could substantially disrupt the ability of the national bank to calculate loan compensation in the manner allowed by its home state laws, and thereby artificially restrain the bank's ability to compete with lenders in the borrower's state.

C. Choice Of Price Structures Furthers Efficient Pricing

The home state interest rule allows consumers to shop nationally for alternative price structures or methods of calculating loan compensation offered under the laws of various states throughout the nation. A consumer who lives in a state that allows periodic percentage charges but no late fees can choose a credit card account from a lender in a different state that allows late fees, thereby reducing the portion of loan compensation that is calculated through periodic percentage charges. Indeed, numerous pricing structures can be offered by national banks in states that do not restrict price structures for loan compensation.

These pricing alternatives provide significant benefits to consumers. Allowing consumers to choose the price structure under which they will pay loan compensation results in issuers' offering the most competitive pricing structures. Consumers are in the best position to determine whether they will be better off paying loan compensation on a periodic percentage charge basis or on some other bases. For instance, consumers who pay their account balances in full each month can choose credit cards with a price structure that has a higher component of the loan price attributable to periodic percentage charges and a lower annual fee because that structure is best for them. Consumers who carry a revolving balance on their accounts instead can choose a price structure that includes an annual fee and reduced periodic percentage charges.

The ability to choose a credit card with late fees benefits consumers by allowing issuers to offer lower APR products. Each of the thirty-one national credit card programs on the Bankcard Holders of America's list of low-cost credit cards, except one, includes a late fee to compensate for the low

APR.[23] Thus, issuers who cannot collect late fees will need to increase the APR or other fees to receive an appropriate level of gross revenues.

Late fees are a fair and efficient method of allocating the costs of operating a credit card program. Borrowers who pay late create operational costs directly attributable to their failure to comply with the terms of their agreements. Credit card issuers must adopt systems to track such behavior and respond to it appropriately. Individuals who pay late also present a greater credit risk than those who pay on time.[24] Lenders thus appropriately demand higher loan compensation for expenses and increased credit risk associated with late payment behavior.

Lenders may consider several different methods of calculating loan compensation to address this. The cost of credit might be increased at loan origination by identifying such behavior on other loans and imposing a higher periodic percentage charge or origination fee. Late fees do the same in

[23] *See* Bankcard Holders of America, *Bankcard Holders of America Low-Interest/No-Fee Credit Card List* (Feb. 1995).

[24] *See* Robert E. Litan, *The Economics of Credit Cards* at 7-8 (Jan. 1993) ("chargeoff rate of customers who at one point have been assessed a late fee has been between four and six times higher than credit losses on all accounts generally"); Edward C. Lawrence, L. Douglas Smith & Malcolm Rhoades, *An Analysis of Default Risk in Mobile Home Credit*, 16 J. Banking & Fin. 299, 311 (1992) ("[F]or loans that are several years old, the borrower's payment history is paramount in estimating default risk. This history is registered through the length of time that the loan has been in effect, the borrower's most recent delinquency status, and frequency of 30-day and 60-day delinquencies in the previous year"); *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564, 567 (1942) ("It is common knowledge that interest rates vary . . . according to the hazard of particular classes of loans. Delinquent taxpayers as a class are a poor credit risk; tax default . . . is . . . a signal of distress").

a more efficient manner by imposing the higher cost in direct response to a late payment. Late fees are no less loan compensation covered by Section 85 merely because they are calculated in this manner.

Limiting the ability of issuers to charge late fees is inefficient because those individuals who cause the expenses and present the higher credit risks associated with such behavior cannot then be required to pay for the consequences of their conduct. Instead, lenders must increase loan compensation in another manner, such as by increasing the APR or annual fee. Many consumers who pay these other charges, however, pay on time. Forcing issuers to recover the costs created by late payers from *all* borrowers provides, in short, an economic subsidy for those who pay late. This inequitable result is exacerbated by the fact that the number of late payers increases as the cost to individuals of paying late decreases.

In sum, consumers are benefited, and the national competitive policies underlying Section 85 are furthered, if consumers can shop nationally for a wide variety of price structures on credit cards.

IV. PRICE CONTROLS LIMIT CREDIT AVAILABILITY AND HARM CONSUMERS

Contrary to Petitioner's suggestion that state limits on credit card late fees benefit consumers, such laws are detrimental to the very consumers whom these laws seek to protect. The intense national competition in the credit card industry efficiently sets the prices for credit by the free market principle of supply and demand. Externally imposed limits on the price at which credit is made available simply restrict the amount of credit that is available, particularly to those borrowers who have the most difficulty obtaining credit. *See*

generally Harold C. Nathan, *Economic Analysis of Usury Laws*, 10 J. Bank Res. 200 (1980) ("Nathan").

The home state interest rule does not restrict the ability of a state to limit the price of credit offered by local national banks. To the extent that the price structure for credit cards allowed by a state's law is desirable to consumers and acceptable to lenders, national banks located in that state will respond to the demand and offer a product at that price to customers who qualify. Similarly, national banks located in states with deregulated price structures will offer credit cards at a competitive price to creditworthy customers, even if not required to do so. Baxter at 1020-21.

A state law limit affects the marketplace where the law sets a price that is lower than the price at which lenders otherwise are willing to make loans to some borrowers. In that case, local national banks and those outside the state will determine that they are unwilling to extend credit at an artificially low price and will limit the availability of credit.[25] Credit cards will not be offered to those individuals who lenders determine are the highest credit risks. Canner & Fergus at 9 ("lower-income families and families headed by younger persons would seem to be among those most likely to be denied credit").

If lenders are constrained by state price limits, they would reallocate resources from those markets that do not allow a competitive return on investment to those that do. The result would be that some lenders would make fewer credit card loans and would increase the supply of other types of credit that are not regulated at artificially low prices. Alternatively, credit card issuers may choose not to make credit card loans

[25] DeMuth at 218; Baxter at 1021-22; Glen B. Canner & James T. Fergus, *The Economic Effects of Proposed Ceilings on Credit Card Interest Rates*, 73 Fed. Res. Bull. 1, 6-7 (1987) ("Canner & Fergus").

to borrowers who reside in states that impose artificially low price limits, resulting in the balkanization of credit availability, in direct conflict with the national competition envisioned by Congress and *Marquette*.[26]

Permitting the borrower's state to impose artificial limits on the availability of credit cards is especially undesirable because, in today's marketplace, the credit card is an important payment device. Credit cards can be virtually indispensable in many common transactions, such as renting a car, making a purchase by mail or telephone, or guaranteeing a hotel room for late arrival. Consumers who use a credit card to make multiple purchases during a month at numerous establishments conveniently receive a single statement itemizing all of those purchases. State laws that effectively restrict the availability of credit cards to less creditworthy consumers deprive those consumers of these important benefits.

V. SECTION 85 INCREASES THE EFFICIENCY OF PROVIDING CREDIT CARD SERVICES

Application of the home state interest rule in place of multiple state interest rules increases the efficiency of credit card issuers that compete nationally. Issuers are able to provide credit services more efficiently if they offer their products under a single federal interest law rather than having to comply with numerous different and often conflicting state laws on loan compensation. These efficiencies are passed

[26] DeMuth at 241-42 ("The benefits of increased competition would be lost if . . . interest rate controls . . . [resulted in] the withdrawal of card programs to state and local markets"); Nathan at 209 ("[U]sury ceilings . . . . cause severe economic distortions that extend far beyond the market they were intended to regulate. The major example of distortion is inefficient resource allocation between states.").

along to credit card customers in the form of lower prices or higher-quality services.

Petitioner argues that a credit card issuer competing nationally should have to adopt a different price structure in each of the states in which it has customers. That would mean issuers would have to comply with a myriad of individual state laws regarding late fees. These state laws many times do not simply provide for a permissible flat dollar amount, but also vary the permissible amount of late fees periodically with changes in the Consumer Price Index, and impose different grace periods before a late fee may be imposed.[27] For those issuers that desire to offer a uniform program nationwide, the requirement of complying with the laws of all states through the "lowest common denominator" essentially prevents the assessment of any late fee.

The complexity of individual state price limits increases exponentially if, as Petitioner's argument suggests, other credit card fees recognized by the OCC as interest are not covered by Section 85. For example, card issuers could be forced to adopt state-specific pricing with respect to annual fees and overlimit fees. The state laws governing these fees likewise are not limited to simple numerical amounts. Some states set rules on the refundability of annual fees, or on how far over limit an account must be before an overlimit fee can be assessed.[28] In a national credit card program, variations in

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[27] *See, e.g.*, Ind. Code § 24-4.5-3-203.5 and Okla. Stat. Ann. tit. 14A, § 3-203(5) (fees vary with CPI); Cal. Fin. Code § 4001(a)(1) ($7 if payment is 5 days late, $10 if 10 days late, or $15 if 15 days late).

[28] *See, e.g.*, Mass. Gen. L. ch. 140 § 114C (annual fee); Cal. Fin. Code § 4001(a)(3) (overlimit by $500 or 120%, whichever is less); S.C. Code Ann. § 37-3-202(1)(c)(ii) (no second overlimit fee unless account balance reduced to the lesser of 10% or $100 below credit limit and then increased to the lesser of 10% or $100 above credit limit).

state laws such as these would create enormous operational burdens.

There are several implications of subjecting national credit card issuers to this level of state price control. From the legal compliance standpoint, it requires card issuers initially to determine the relevant state law limits through review of state statutes, regulations, interpretive letters and cases. In the highly technical consumer credit area, this undertaking is substantial in a single state, let alone a large number of states. Issuers also must continuously monitor statutory, regulatory, and other developments in the laws of various states, and adapt their programs accordingly. Such compliance efforts, while not impossible, are tremendously expensive for issuers and consumers.

Complicated operational issues also need to be addressed. The computer systems used for billing on the accounts need to be programmed to reflect all of the individual state variations. Different forms of agreements are needed for different states, or complicated forms showing the relevant fees for residents of the various states are necessary. Changes in these state law-specific systems and agreements are required when a consumer moves to a different state. Customer service representatives answering questions from on-line data systems need to know the particular state fee structure applicable to each cardholder.

A likely consequence of this burden would be that fewer issuers would be able to compete nationally. Card issuers would not have the nationwide market in which to achieve the economies of scale that have assisted the development of large credit card programs. Evans & Schmalensee at 28-29. Similarly, issuers would need to adopt particular underwriting and credit policies based on the price structures of their home state that must be revised if pricing structures vary between states. The added complexity of state-by-state price

regulation will benefit only the lawyers and other service providers who will be needed to develop and maintain the compliance structure necessary for the additional regulatory burden.

In sum, Petitioner's theory, if adopted, would result in fewer credit card issuers, higher interest charges, and less consumer choice, thereby undermining the very purposes of Section 85.

CONCLUSION

Petitioner's interpretation of Section 85 is inconsistent with the national competition that was envisioned by Congress and recognized by *Marquette*, and would not benefit consumers. The decision of the court below thus should be affirmed.

Respectfully submitted,

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